26 June 2018

Jo Perry
Commerce Commission
44 The Terrace
Wellington

By email : regulation.branch@comcom.govt.nz

Dear Jo,

1. Air New Zealand welcomes the opportunity to offer a cross submission to the Commerce Commission's draft report into AIAL's price setting decisions (PSE3) which have defined prices for customers payable between 1 July 2017 to 30 June 2022. We would like to take this opportunity to acknowledge the work put in by Commission staff and by all submitters to the review process, and look forward to the conclusion of this work in November 2018.

Draft findings from the Commission: AIAL may not be limited in its ability to extract excessive profits

2. The Commission's draft report, *Review of Auckland International Airport's pricing decisions and expected performance (July 2017 – June 2022),* as published 26 April 2018, found that AIAL may have set target returns which are too high, and which allow AIAL to earn excessive profits.

"*Auckland Airport has not sufficiently justified the returns it is targeting on its regulated asset base (RAB). Given this, we are not yet confident that Auckland Airport will be limited in its ability to extract excessive profits over the PSE3 period.*"[1]

Information disclosure has not restrained AIAL from targeting excessive profits

3. Under current regulatory settings, AIAL must set prices at least every five years, and is regulated by Information Disclosure regulation. Information disclosure is the lightest form of regulation available under Part 4 of the Commerce Act, and requires annual reporting of specified metrics and price setting disclosures according to a format set by the Commission.

4. AIAL has made its price setting disclosures for Price Setting Event Three (PSE3) as required, and has included target returns of 7.06%.[2] These returns are now

[1] Commerce Commission: Draft report, X6.
[2] 7.06% made up of 6.99% for aeronautical services and 7.9% for other regulated services.

being compared to those returns the Commission considers benchmark returns for AIAL[3], a vanilla WACC of 6.41%.

5. The Commission considers that AIALs target return of 7.06% will allow it to recover some $65M in excess profits. Airports consider that they have a right to set target returns as they see fit. The Commission's publication of vanilla WACC, and the requirement to make information disclosures, is expected to be enough of a driver to restrain specified airports like AIAL from making excessive profits. As the target returns set and already being paid by customers of AIAL demonstrate, information disclosure alone has not restrained AIAL from targeting excessive returns.

6. The Commission's review of PSE3 for AIAL has set out a clear assessment framework, so that it is easy to see how excess returns have been targeted. The Commission requested more information from AIAL to justify the difference between its target returns, and the Commission's benchmark returns. Air New Zealand has now been able to review AIAL's submissions, and is pleased to make the following cross submission.

AIAL submits that the Commission's assessment process is inflexible, and does not rely on 'judgement'

7. AIAL submit that the assessment framework put forward by the Commission is *'inconsistent with the flexible and contextual profitability assessment that was signalled through the IM review'.* [4]

8. AIAL submits that they expected there would be less emphasis on specific WACC percentiles, and more emphasis on understanding the inputs to these percentiles, against the airport specific context.[5] Air New Zealand contends that this is, in fact, exactly what is occurring in the Commission's assessment process. It is not the final WACC percentile that is ultimately held up as a concern, it is how that percentile was arrived at, and the effect of that percentile against a mid-point WACC – whether that additional recovery can be justified.

9. In setting its prices, and in the process of justifying them to the Commerce Commission in the PSE3 review, AIAL has relied frequently on the concept of judgement:

10. *"An element of judgement will always be required by airports when setting prices, and by the regulator when assessing the reasonableness of those decisions."*[6]

[3] Commerce Commission: Draft report, X7.
[4] Section 53B review of Auckland Airport's pricing decision and expected performance for PSE3: submission on the draft report: 29 May 2018 para 49.
[5] *Ibid*, para 12 (a).
[6] *Ibid*, para 12 (f)

11. *"However, the reality remains that our final decision on the appropriate target return for aeronautical pricing activities was a judgement call informed by evidence – and it would not have been possible for us to set out a mechanical parameter-by-parameter explanation of how our target return differed to the Commission's WACC, nor mechanically quantifying the step down in target return from our assessed Auckland-Airport-specific midpoint WACC estimate."*[7]

12. Air New Zealand considers that if AIAL is to make such a significant departure from the mid-point WACC, it owes consumers a clear and transparent explanation about how this difference arises – and that the Commission's assessment process has allowed for this transparency. To ask the Commission to make a judgement call without process is at best irresponsible, and at worst an attempt to disguise the manner in which excess revenues are recovered.

The capital investment programme does not justify an increased WACC based on operating leverage

13. Target revenues considered by the Commission cover prices to be recovered from 2017 to 2022. Over this period, AIAL claim that they will commence a significant capital programme. Air New Zealand is fully in support of this necessary and urgent capital investment programme.

14. At time of writing (mid-2018) we have four years of the period still to run. Facilities at AIAL are congested on tarmac, in the terminal and across the airport campus as a whole. While we have seen some improvement with the completion of Pier B in the international terminal, the domestic terminal is well past the end of its useful life. Plans for the proposed integrated terminal are still being reviewed. Air New Zealand is not the only user of the airport to have advised AIAL that plans as they stand for the integrated terminal are insufficient to withstand expected tourism growth and transit throughput.

15. Air New Zealand has been in a consulting cycle on the development of the new terminal since at least 2012. Air New Zealand is concerned that while consultation will continue, actual building of the new terminal will not commence according to published timelines, which means that capital expenditure will not be contracted by AIAL as planned. As time moves on, prices for building materials increase, and new requirements are added.

16. Air New Zealand certainly wants the very best possible terminal of the future, as Auckland is our home port. However, experience suggests that progress on building the new terminal will be slow. As set out in the TDB Consulting report attached to the BARNZ submission, the existence of a large future capital programme is not in itself justification for an increased cost of capital due to operating leverage. A capital programme does not commit that capital. The amount of capital spent is usually lower than expected in the programme, and

[7] *Ibid*, para 39

the asset owner has regular decision points throughout the programme as to whether to commit to the next capital outlay.

17. It is over the course of each year that capex is contracted. Without contracting a build process, AIAL may well be planning for capex, and planning to fund it, but capex is not committed to. Without such commitment, operating leverage is not affected in the way that AIAL claim that it is.

Incentives to invest are based on AIAL shareholders achieving excessive returns

18. AIAL submits that without achieving the 58 basis point premium on the Commission's mid-point WACC it will be insufficiently incentivised to invest, and that it may be difficult to raise required funding.[8]

19. Air New Zealand submits that this is based on the assumption that shareholders of AIAL will only invest if they are earning returns that are excessive to the market. There is no evidence to support this contention and it is wrong in both theory and practice. A normal return on investment will create healthy incentives to invest, and as the Commission points out in its draft report, AIAL's incentive to invest arises from benefit that growth brings to its commercial till.

20. Failing to create airport infrastructure to accommodate forecast growth in volume of passengers would reduce AIALs ability to maximise commercial till profitability. The dual till model in itself should incentivise airport companies to invest in aeronautical infrastructure.

21. AIAL submit that the investment in its regulated activities is having an adverse impact on its second till activities[9]. If the AIAL believes this is a barrier to investment then Air New Zealand would welcome the inclusion of these activities through a single till regulatory model which would enable consumers to benefit from the ancillary activities that arise only due the existence of the airport.

Other regulated activities also target excess revenues

22. The Commission's draft report finds that other regulated activities also target excess revenues, in a similar manner to aeronautical services. AIAL submits that the market based lease approach it employs to recover revenues from these contracts is reasonable, and that market based rent reviews are employed through the period.

23. While it is true that rent reviews are conducted, it is Air New Zealand's experience that we pay market prices aligned to high end commercial spaces,

[8] *Ibid*, para 131
[9] *Ibid*, para 136(b)(iv)

rather than, as is often the case, degraded assets. In many cases, we are unable to invest in leased facilities, as many of these may move as part of the terminal redesign. This means that we are often unable to work to improve business operations or working conditions for staff.

The $65 million dollar question

24. These cross submissions represent the last word from all parties on AIAL price setting event until the delivery of the Commission's final report at the end of 2018. The Commission may find that AIAL have targeted $65M of excess returns in PSE3.

25. If the Commission find that AIAL have targeted excess returns, AIAL could chose to return those revenues already recovered, and reset prices. However, under current regulatory settings, AIAL can also chose to do precisely nothing, and keep these revenues. This is because, despite all the work of the Commission in setting Input Methodologies, in publishing a vanilla WACC, in receiving annual Information Disclosures and assessing Price Setting Events, the Commission is unable to require AIAL to set returns according to a benchmark.

26. The settings in the Commerce Act for regulation of airports, and in the Airports Authorities Act in support of the ability for airports to price as they see fit, have so far enabled Airports to set, and keep, excessive returns. Changes to the entire regulatory environment are urgently required to effectively constrain airports.

27. Air New Zealand has submitted in support of changes to the Commerce Act allowing for firmer oversight of airports which target excess revenues. We also look forward to revision of the Airports Authorities Act later this year. It is only with total alignment of regulatory settings will monopoly airports be incentivised to act in the long term best interest of consumers.

Regards

Jeff McDowell
Chief Financial Officer
Air New Zealand